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# CHICAGO

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## COASEAN BARGAINING IN CONSUMER BANKRUPTCY

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## Coasean Bargaining in Consumer Bankruptcy

Edward R. Morrison<sup>1</sup>

During my first weeks as a graduate student in economics, a professor described the Coase Theorem as “nearly a tautology:” Assume a world in which bargaining is costless. If there are gains from trade, the Theorem tells us, the parties will trade. The initial assignment of property rights will not affect the final allocation because the parties will bargain (costlessly) to an efficient outcome. “How can that be a theorem?,” I remember thinking at the time.

But my professor had missed something important. With his theorem, Coase changed fundamentally the way we ask questions. Instead of treating laws as fixed objects that influence behavior, we see them as elements of a bargaining environment. We look for frictions in the institutional or contractual environment that prevent parties from bargaining around the law. Coase, in other words, forces us to confront the questions that are both most important and hardest to answer: Why does law matter? When does it matter?

An example from my own work offers one of many possible illustrations of how Coase still sets the agenda for legal scholars. Roughly speaking, there are two types of consumer bankruptcy, Chapters 7 and 13. In Chapter 7, the debtor

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<sup>1</sup> Paul H. & Theo Leffmann Professor of Commercial Law. I thank Douglas Baird for comments and Vivek Sampathkumar for excellent research assistance. This essay grows out of work with my co-authors, Arpit Gupta, Richard Hynes, Christopher Mayer, and Tomasz Piskorski.

receives a discharge by giving up assets. In Chapter 13, she receives a discharge by giving up disposable income for three to five years. It is often said that an advantage of Chapter 13, relative to Chapter 7, is that the debtor can “save” her home from creditor collection efforts. This is because Chapter 13 allows the debtor to retain all of her assets, provided she returns to paying her mortgage on time and adheres to the terms of her Chapter 13 plan.

But why should law—Chapter 7 or Chapter 13—affect the allocation of a property right in the debtor’s home? Even if she files a Chapter 7 bankruptcy filing, she can renegotiate with her mortgage lender. If the value of the home is higher in her hands (because she will repay the mortgage) than in the lender’s (which will sell the home at foreclosure), the parties should reach a bargain that allows the debtor to keep her home, even if she files for Chapter 7 bankruptcy. This is Coasean bargaining at work. Practicing lawyers call it “ride through,” and it is empirically important. I assembled a database with credit report information about debtors with subprime mortgages who filed for bankruptcy between January 2005 and June 2011.<sup>2</sup> I followed the debtors from the date of the bankruptcy filing through June 2012. For each debtor, I computed the length of time between the bankruptcy filing and the date (if any) that the mortgage was

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<sup>2</sup> The data are described in Christopher Mayer, Edward Morrison, Tomasz Piskorski, and Arpit Gupta, “Mortgage Modification and Strategic Behavior: Evidence from a Legal Settlement with Countrywide,” NBER Working Paper No. 17065 (2012).

closed out prior to maturity or repayment in full. The close-out date is a proxy for the date the debtor loses her home. The Table below presents the results by filing year. Looking at bankruptcy filings during 2005-06, for example, we see that twenty percent of Chapter 7 filers and thirteen percent of Chapter 13 filers lost their homes within the first year after filing. By the end of five years, sixty-three percent of Chapter 7 filers and sixty-two percent of Chapter 13 filers had lost their homes. By the end of seven years, the difference between Chapter 7 and 13 filers had reversed: Chapter 13 filers were more likely to have lost their homes. We see roughly similar patterns when we look at homeowners who filed for bankruptcy in other years, though we cannot (yet) track their post-bankruptcy experience for a full seven years. In 2007, for example, twenty percent of Chapter 7 filers and nine percent of Chapter 13 filers lost their homes during the first year after their bankruptcy filings. That's a large (127 percent) difference between Chapter 7 and 13 filers, but the difference attenuates substantially over time.

These patterns tell us two things. First, Coasean bargaining ("ride through") is empirically important: A large percentage of Chapter 7 filers are able to keep their homes during the first few years after the filing. Second, the probability of retaining a home is higher among Chapter 13 filers, but the

difference between Chapter 13 and Chapter 7 filers narrows over time and, over long time horizons, can even reverse.

Why does Chapter 13 lead to a different allocation of property rights? What bargains does it permit that are not possible in Chapter 7? This is how the Coase Theorem shifts the way we think about the law. Instead of asking why Chapter 13 is used to “save homes,” we should ask why Chapter 7 inhibits the outcomes we see in Chapter 13.

Asymmetric information provides one story. Suppose the mortgage lender knows that one-third of borrowers can repay their mortgages and two-thirds cannot, but it cannot distinguish borrowers who can repay from those who cannot. If the lender forecloses on all mortgages (“mass foreclosure”), it will experience a loss equal to thirty percent of each borrower’s outstanding balance. If it instead offers “ride through” to all borrowers, the lender will avoid foreclosure in one-third of the cases (these borrowers will repay their mortgages), but it will eventually pursue foreclosure in the remaining two-thirds, and the losses from those foreclosures will be larger—equal to fifty percent of the outstanding balance—than the losses from immediate foreclosure (because delayed foreclosures are more costly). Under these assumptions, the expected loss from “ride through” is  $\frac{2}{3} * 50\% = 33\%$ . Although the lender experiences default less often (two-thirds of the time), the expected loss from ride-through is

greater than the expected loss from mass foreclosure. The lender will therefore foreclose.

A debtor can try to avoid this outcome by filing for Chapter 13. The bankruptcy judge can confirm a Chapter 13 plan that gives the debtor the opportunity to repay the mortgage, even if the lender objects. But is it efficient for the judge to do this? Does the judge know more than the lender about the debtor's repayment prospects? Why?

These are the difficult and interesting questions raised by our consumer bankruptcy system, and they become visible only when the law is viewed through a Coasean lens. Far from being a tautology, Coase's insight reframes legal questions and prompts us to rethink (and think more deeply about) the ways law affects behavior.

**Table**

**Mortgage Outcomes By Bankruptcy Chapter and Filing Year**

This table presents the fraction of debtors whose first mortgages are closed prior to repayment. The underlying data are drawn from a database that links mortgage payment data provided by BlackBox Logic LLC with credit report information provided by Equifax, Inc. Nearly 90% of all subprime mortgages originated after 1999 are included in the database, which tracks loan outcomes from 2005 through 2012. I subset on first mortgages held by borrowers who lived in single-family homes and filed for Chapter 7 or 13 bankruptcy between 2005 and June 2011. A loan is treated as “closed” if it drops out of the database prior to July 2012 at a time when the loan has not been paid off, is in foreclosure, or has been liquidated or when the property is real estate owned (REO) or subject to a forced sale. A loan is treated as a “first mortgages” if it had one of the following characteristics in the BlackBox database: (i) a lien type equal to “first” or (ii) a lien type equal to “unknown” but an origination loan-to-value ratio greater than 55. Additionally, my analysis excludes mortgages encumbering second homes, loans held by investors, and loans for which Equifax did not report a “high confidence” linkage between BlackBox and Equifax data.

	Proportion of First Mortgages Closed Within			
	1 Year	3 Years	5 Years	7 Years
<i>2005-06 Filings (n=19,026)</i>				
Chapter 7	0.20	0.57	0.63	0.78
Chapter 13	<u>0.13</u>	<u>0.52</u>	<u>0.62</u>	<u>0.89</u>
Difference	0.07	0.05	0.01	-0.11
% Difference	51%	9%	1%	-12%
<i>2007 Filings (n=21,283 loans)</i>				
Chapter 7	0.20	0.63	0.86	
Chapter 13	<u>0.09</u>	<u>0.44</u>	<u>0.79</u>	
Difference	0.11	0.19	0.07	
% Difference	127%	43%	9%	
<i>2008-09 Filings (n=73,293 loans)</i>				
Chapter 7	0.14	0.64		
Chapter 13	<u>0.07</u>	<u>0.49</u>		
Difference	0.07	0.15		
% Difference	107%	30%		
<i>2010-11 Filings (n=54,106 loans)</i>				
Chapter 7	0.09			
Chapter 13	<u>0.04</u>			
Difference	0.05			
% Difference	113%			

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